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The many faces of an income statement

By **THEMIN SUWARDY**
 and **KHOO TENG AUN**

WHEN a company announces its financial results, most analysts and media coverage tend to focus on its income statement, usually with year-on-year or other periodic comparisons of performance.

Typically, one would probably expect to see the revenue that the company generated and the expenses incurred to earn the revenue, resulting in a net profit for the period. Thus, for a merchandiser, one may expect line items such as sales revenue and its corresponding cost of sales or cost of goods sold in the income statement.

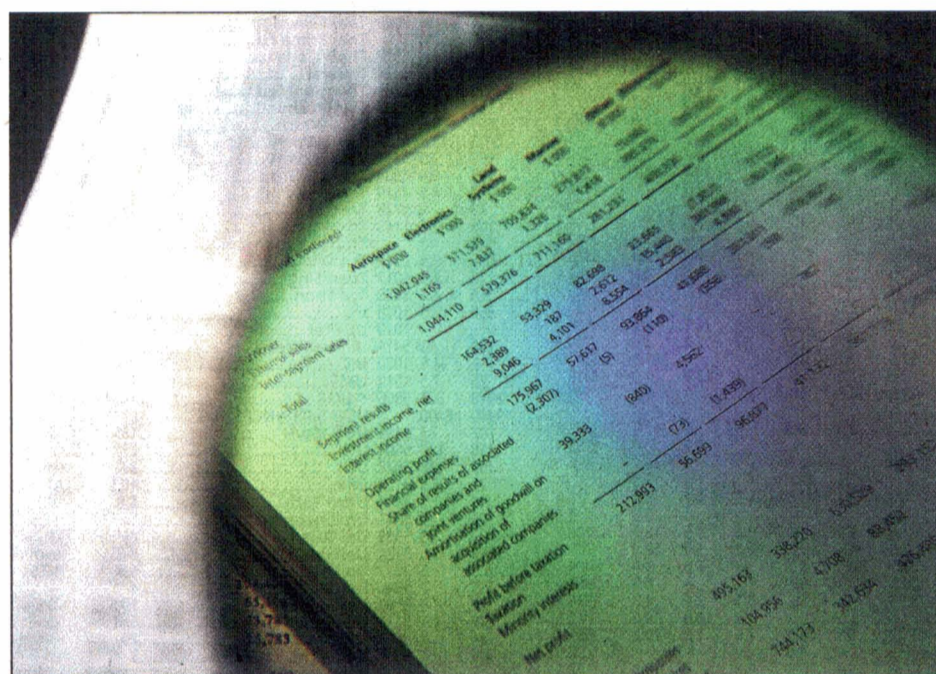
Indeed, this is the primary contention in Jamie Lee's article on June 8 ("RSH Income Statement can be clearer", BT). RSH's income statement was criticised because it did not explicitly disclose the cost of goods sold or cost of sales expense line item.

Readers were correctly advised that this could have been calculated using the two items disclosed in RSH's income statement ie cost of "raw materials and other consumables" minus the "changes in value of inventories". Further, criticism was levelled at RSH for not making additional explanation of what the latter line item, "changes in value of inventories", really means.

Singapore Financial Reporting Standards 1 (FRS 1) prescribes two expense classifications for Income Statements: "An entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity."

Without getting into too much technical details, the "nature" classification was what RSH used, including the two lines of contention: the cost of "raw materials and other consumables" and the "changes in value of inventories".

Under this classification, an entity aggregates its expenses according to their nature (for example, depreciation, cost of materials, transport costs, and employee benefits). Generally the nature method is



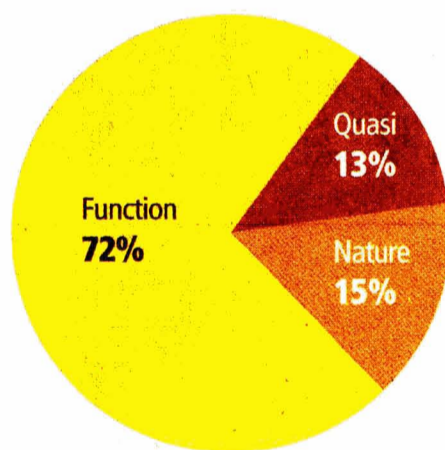
YEN MENG JIIN

Close scrutiny: Most analysts tend to focus on a company's income statement, usually with year-on-year comparisons of performance

Methodology

Who's doing what

- Companies such as:
- Aussino
 - Breadtalk
 - Dairy Farm
 - Eu Yan Sang
 - Novena
 - Popular
 - Wing Tai



- Companies such as:
- Challenger
 - CK Tangs
 - Isetan
 - Lifebrandz
 - OSIM
 - RSH

Source: SMU

"easier" to prepare as it avoids allocation of expenses to the various functions of the entity. A pure "nature" classification will thus have no cost of sales line item.

On the other hand, if an entity decided that a functional classification is more reliable and more relevant, it would classify expenses as part of cost of sales, marketing costs, distribution costs, administrative costs, or other functional groupings. At a minimum, FRS 1 re-

quires companies using this classification to disclose cost of sales separately from other expense items.

The choice between the function and nature of expense method depends on historical and industry factors and the nature of the entity. Both methods have merits for different types of entities and management must select the presentation that in its opinion is the more reliable and more relevant.

Let's take a common expense

item such as staff benefits expense. Financial statement users would have no problem understanding the "nature" of this cost. However, if we were to allocate staff costs by function, one would have to classify staff costs into all the functions of the entity, eg the wages of an employee working in the marketing department would be allocated to selling and distribution expenses (together with many other expenses related to the marketing function), the wages of an employee working in the corporate head office would, similarly, be allocated to administrative expenses (again, together with many other expenses related to this function).

While this may offer higher relevance to some users, what readers need to understand is that the process of allocating costs to various functions may involve considerable management judgement. In fact, the classification by function may be so arbitrary that FRS 1 requires entities using this method to provide additional information on the nature of the expenses.

We looked at over 50 retailers listed in the Singapore Exchange and noted that a significant majority (72 per cent) of companies are using the function method, with 15 per cent using the pure nature method. The other 13 per cent have income statements that are "quasi-nature" or "semi-functional" in format, often with a cost of sales line but followed by some expense items by nature (ie not grouped into functional areas).

At the end of the day, it is important for financial statement readers to understand that there is no one better format than another. Done correctly, both function (with cost of sales) and nature (without cost of sales) offer useful information to financial statement readers.

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